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Supreme Court of the United States

OCTOBER TERM, 1940.

No. 253.

EUGENE HIGGINS,

Petitioner,

v.

GUY T. HELVERING, Commissioner of Internal Revenue,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF OF AMICUS CURIAE.

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BRIEF OF AMICUS CURIAE.

This brief is filed by the undersigned as *amicus curiae* with the written consent of counsel for the respective parties.

The brief will be limited to a discussion of the administrative practice referred to in the petitioner's brief pursuant to which all reasonable and necessary expenses incurred in securing or earning income by a regular and continuous course of action have uniformly, since the inception of the income tax, been deductible as "business" expenses.

In Determining Gains, Profits or Income Derived From Transactions, It is Inherently Necessary to Take Account of the Cost or Expense of Such Transactions.

The administrative practice was based upon a broad interpretation of business as "any transaction entered into for profit", and "carrying on business" as a continuous, regular series of such transactions—the interpretation adopted by this Court at an early date (*Flint* v. *Stone Tracy Co.*, 220 U. S. 107, 171; *Edwards* v. *Chile Copper Co.*, 270 U. S. 452).

The broad interpretation is in harmony with the general understanding of the ordinary man, who speaks of a "business" trip as distinguished from a "pleasure" trip, a "business" letter as distinguished from a "personal" letter, a "business" engagement as distinguished from a "social" engagement, and who, even before the days of the income tax, regularly segregated his "business" expenses from his "personal, family and living" expenses.

The Government's contention would appear to be based on somewhat the following theories: That Congress has the power to impose, and has imposed, the tax on gross income, less only certain deductions specifically allowed in the statute; that no deductions not specifically allowed can be claimed by the taxpayer and the burden is on the taxpaper to show that he is entitled, by the clear and unambiguous language of the statute, to any deduction that he claims; that Section 23(a) allows the deduction of the ordinary and necessary expenses of carrying on any trade or business, and does not allow the deduction of any other expenses; that "carrying on any trade or business" does not comprehend all activities

in the production of income, no matter how regular and continuous such activities may be; that the phrase has a narrower meaning, being limited practically to "carrying on a trade, vocation or profession"; that to the extent that the Treasury has undertaken to allow deductions for expenses incurred in the production of taxable income, to a taxpayer not engaged in trade or business within such narrower definition, the practice embodies an incorrect interpretation of the statute and should not be followed.

We think the Government puts the shoe on the wrong foot. We believe that the cost or expense of securing or producing income must be taken into account *in order to determine the amount of the income,* except to such extent as may be expressly prohibited by statute.

It is unnecessary to argue whether Congress has the power under the Sixteenth Amendment to impose a tax on gross receipts. It is perfectly obvious that Congress has not attempted to impose such a tax. The income tax is and always has been laid on "gains or profits and income derived from any source whatever" (Section 22(a)).

In *Eisner* v. *Macomber,* 252 U. S. 189, this Court approved an earlier definition which it had placed upon the word income, as "*the gain* derived from capital, from labor, or from both combined", adding that it must be understood, however, to "include *profit* gained through a sale or conversion of capital assets". This definition, of course, was intended to have the broadest scope. "Capital" was intended to include property of all kinds and "labor" to comprise all effort. In short, the taxpayer is taxed upon any *gain* arising from his property or from his mental or physical efforts of any kind.

The receipts of a taxpayer may include or even constitute income, but that is not necessarily so. We are here speaking, not merely of "net income", the artificial concept of the income tax law, but of any actual income.

In order to determine whether and to what extent particular receipts constitute or comprise income, it is essential to take into account the cost of producing or securing those receipts. It is inherent in the very concept of income that, to the extent receipts represent merely a return of capital cost or other necessary expense, they do not constitute gain or profit. A manufacturer's income (even his "gross income") consists, not of the gross receipts from the sale of goods, but of such gross receipts minus the manufacturing cost of the goods sold. The receipts from a sale of property do not constitute income; the income is only the excess of such receipts over the cost of the property sold. These illustrations, which are recognized on the income tax blanks prepared by the Treasury, could be multiplied almost without end.

There is no difference in this regard between capital transactions and ordinary income transactions. In either case, the money expended by the taxpayer, being already his own, does not become income when returned to him.

We do not deny that Congress has full discretionary power to deny, restrict or condition the allowance of deductions to be taken *from* "gross income" in order to compute the "net income" on which the tax is laid. We concede that if a taxpayer who has derived a gain, profit or income seeks to diminish it by an unrelated expense, loss or other deduction, the burden is on him to show his right to it under some

express provision of the statute. But since Congress has laid the tax only on income in the sense of gains and profits, and since the gain or profit from a transaction or a series of transactions cannot be ascertained without taking account of the cost or expense thereof, it seems perfectly clear that the reasonably necessary expenses of earning or securing income, including the expense of managing and preserving income-producing property, real, personal or mixed, tangible or intangible, are allowable in some form in computing the taxpayer's income tax liability, except to the extent the allowance thereof is denied, restricted or conditioned by some express provision of the statute.

There is a real difference between a statutory deduction *from income* already determined and a necessary deduction of cost *in computing income* (*Woolford Realty Co.* v. *Rose*, 286 U. S. 319, 328-9). This difference always has been recognized by the Treasury Department.

For example, if a "gentleman farmer" carrying on farming operations for pleasure and not for profit, and admittedly not engaged in business, takes in $2,000 from his farm operations in a year, but necessarily expends $1,000 in doing so, his *income* from his farm operations is $1,000, not $2,000, and yet there is no express provision of the income tax law allowing the "deduction" of any of his expenses. Moreover, if his expenses exceed his receipts, although the excess is not deductible *from other income* as a loss under Section 23(e), because it was not incurred in business or in a transaction entered into for profit, nevertheless, the expenses are allowable to the extent of the receipts, so that the taxpayer reports no "in-

come" from his farming operations (Regulations 7
Article 131).

In the case of a single, isolated transaction, co
cededly not effected in "carrying on any trade
business", the cost or necessary expense of the tran
action must be taken into account in determining th
gain, profit or income therefrom, and yet there is n
provision of the income tax law specifically allowin
a "deduction" for such expense or cost.

For example, if a man who lives in a rented hous
moves to another town and sublets the house he ha
been occupying for the balance of his term for les
than the rent he pays his landlord for such house
no one would contend that he has thereby made a gai
or profit.

Commissions paid to a broker on an isolated pur
chase and sale of property, though clearly not allow
able as expenses of carrying on a business, ar
nevertheless taken into account in computing the re
sulting gain or loss. (See *Hekering* v. *Winmill*, 30
U. S. 79.)

There is, however, a practical difference in th
treatment accorded under the income tax law to th
cost or expense of a single, isolated transaction an
the expenses of carrying on trade or business. Th
cost or expense of a single, isolated transaction, no
being specifically allowable as a "deduction" unde
Section 23(a), is taken into account in computing th
amount of the income from the transaction at the tim
the transaction is closed or completed.

The general expenses of a trade or business (a con
tinuous, regular course of activity undertaken fo
profit) are not allocated, *pro rata*, to the numerou
individual transactions effected in the course of th

trade or business, and taken into account proportionately when and as each transaction is completed, but are allowed as "deductions" in the year in which they are incurred or paid, while the income from the trade or business is taken into account in the year in which it accrues or is received.

Thus, in the case of a trade or business, the expenses do not always or necessarily offset the income derived from the transactions in the conduct of which the expenses are incurred. The business is treated and the income tax liability is computed on an annual basis. This avoids the necessity of undertaking to allocate such general recurring expenses to the various individual transactions constituting the conduct of trade or business.

The Treasury Department, in treating as business expenses the cost or expense of owning and preserving income-producing property and the production and collection of income therefrom regularly and over an extended period, has merely placed such expenses on an annual basis for income tax purposes and has not attempted to take into account any expenses not inherently allowable in the computation of income tax liability.

One contention advanced by the Government in other cases demonstrates conclusively the proposition just stated. While Section 23(a) allows deductions for ordinary and necessary expenses incurred in carrying on any trade or business, Section 23(e) allows deductions for losses, if incurred in trade or business, "or if incurred in any transaction entered into for profit, though not connected with the trade or business." The Government contends that the difference between these two provisions shows that Congress did not intend, in Section 23(a), that expenses of trans-

actions entered into for profit should be taken into account, unless they were incurred in carrying on trade or business. The argument leads to absurd results.

Assume a single, isolated transaction entered into for profit but concededly not in connection with the continuous conduct of trade or business, and assume that the gross receipts from the transaction amount to $2,000, before taking account of the necessary cost or expense. Under the Government's contention, if the total cost or expense was only $1,000, no part thereof may be taken into account, and the taxpayer is taxable on "income" of $2,000 derived from the transaction, whereas, it is clear that if the cost or expense of the transaction exceeded $2,000, all of such cost or expense must be taken into account, and the excess thereof over the gross receipts is allowable as a loss. That, of course, would be unreasonable and unjust. The intention to enact legislation which would achieve such a result will not lightly be imputed to Congress by this Court.

The reason for the express provision in Section 23(e) allowing losses in transactions entered into for profit, though not connected with a trade or business, whereas Section 23(a) contains no similar provision with respect to the deduction of expenses, is perfectly clear. There is no such thing as minus income (*Woolford Realty Co.* v. *Rose*, 286 U. S. 319), and there is no inherent right to diminish or offset income from one transaction by a loss from an entirely distinct transaction. Since Congress apparently wanted to allow such a loss, it was necessary to say so in Section 23(e). But, since the cost or expense of any transaction must necessarily be taken into account in computing the income from that particular trans-

action, there was no necessity for an express provision of the law to that effect.

It being clear that the necessary cost or expense of producing income must in all cases be taken into account in determining what part of the gross receipts constitutes income, it seems equally clear that the Treasury Department was justified in adopting an administrative practice under which the identifiable cost or expense of any single, isolated transaction is to be taken into account at the time such transaction is closed, in order to compute the income arising therefrom, while the cost or expense of a regular, continuous series of transactions should be taken into account on an annual basis. The practice is not only entirely reasonable, but is necessary to a practical, common-sense administration of the act.

There certainly is no justification for refusing to take into account, *on some basis*, the regular recurring expenses of a continuous series of income-producing transactions, while at the same time the cost or expense of any single, isolated transaction is taken into account. There is even less justification for refusing to take into account the cost or expense of an income-producing isolated transaction if it results in a profit, but taking such cost or expense into account if it results in a loss.

The Real Purpose Back of the Government's Contentions in This Case.

We cannot believe that there is a serious desire on the part of those responsible for the administration of the income tax law to confuse the fundamental concept of "income" by treating it as synonymous with gross receipts in an arbitrarily selected class of cases.

In fact, there is evidence which leads us to suspec that the contentions being raised in this and certai other recent cases result, not from any abandonmen by the Treasury of the fundamental principle em bodied in the former practice, but from a desire t achieve indirectly a different objective which con cededly cannot be accomplished directly under th statute.

After the practice of allowing as business expense all reasonable and necessary expenses of earning o securing income and managing and preserving income producing property had been in effect for man years, the Treasury concluded that it was unfai to allow a taxpayer to deduct from his *taxable incom* the cost or expense of earning *tax-exempt income* Accordingly, in 1931, a Treasury ruling was issued t the effect that the expenses of a taxpayer who receive both taxable and tax-exempt income should be allo cated between the two classes of income and the por tion thereof allocated to the tax-exempt income shoul not be allowed. This ruling (G. C. M. 9954, X- Cum. Bull. 253) overruled a previous ruling in whic it had been held that the statute did not justify suc allocation (G. C. M. 7668, IX-1 Cum. Bull. 221).

Later in the same year (1931), the matter was re considered and a new ruling was issued which greatl modified and practically overruled G. C. M. 9954, o the authority of this Court's decision in *Missou Insurance Company* v. *Gehner*, 281 U. S. 313 (G. C M. 10123, X-2 Cum. Bull. 254).

After concluding that there was no authority unde the then existing law to disallow the deduction o expenses allocable to the production of tax-exemp income, the Treasury in 1934 sought an amendmen

to the law which would forbid the allowance of otherwise allowable deductions to the extent that they were incurred in the production of tax-exempt income. The amendment was passed by the House. The report of the Committee on Ways and Means (House of Representatives, Report 704, 73rd Congress, 2nd Session; 1939-1 (Part 2) Int. Rev. Cum. Bull. p. 571) contains the following explanation:

> "This paragraph has been added to the bill to eliminate as deductions from gross income expenses allocable to the production of income wholly exempt from the income tax. Under the present law interest on State securities, salaries received by State employees, and income from leases of State school lands are exempt from Federal income tax, but expenses incurred in the production of such income are allowed as deductions from gross income."

However, the Senate amended the provision so as to exclude from its operations expenses incurred in earning tax-exempt *interest*. The report of the Senate Finance Committee (Senate Report 558, 73rd Congress, 2nd Session; 1939-1 (Part 2) Int. Rev. Cum. Bull. p. 606) contains the following explanation:

> "The House bill disallows amounts otherwise allowable as deductions which are allocable to one or more classes of tax-exempt income. * * * While your Committee is in general accord with the House provision, it is not believed that this disallowance should be made to apply to expenditures incurred in earning tax-exempt interest. To do so might seriously interfere with the sale of Federal and State securities, which would be unfortunate during the present emergency."

The amendment as enacted in the Revenue Act of 1934, and reenacted in subsequent acts (Section 24(a)(5)), merely provides that "any amount otherwise allowable as a deduction which is allocable to one or more classes of income *other than interest* * * * wholly exempt from the taxes imposed in this chapter" shall not be allowed.

Although Congress thus definitely expressed its wishes on the subject, the Treasury did not abandon its efforts to disallow such expenses. Shortly before the Revenue Bill of 1934 was introduced in Congress, the Treasury published I. T. 2751, XIII-1 Cum. Bull. 43, in which the settled administrative practice was referred to as "resting upon the sound basis that business expenses represent the cost of producing income", but in which it was held specifically that "all the ordinary and necessary expenses paid or incurred during the taxable year with respect to the management, production and conservation of properties producing *taxable* income should be allowed as deductions in computing net income."

After the enactment of the 1934 Act, and despite the fact that the amendment contained therein did not disallow expenses incurred in earning tax-exempt *interest,* the Treasury adopted the policy of attempting to secure the disallowance of expenses allocable to tax-exempt interest wherever possible, by denying the deduction of all expenses incurred in the ownership and management of securities and the collection of income therefrom, on the ground that such expenses are not incurred "in carrying on any trade or business", *except where a taxpayer would consent to the allocation of such expenses between taxable and tax-exempt interest, in which case the Treasury has regularly allowed the portion of the expenses allocated to the taxable interest.*

The foregoing has been and continues to be the administrative practice up to the present time, despite the decisions below in this case and other similar cases. I. T. 2751 never has been revoked. On inquiry, we have been assured by the Treasury that it is still in effect and that instructions have been issued to the field service of the Internal Revenue Bureau to continue to follow it. Cases have been and still are being closed on the basis of allowing expenses of earning taxable income, including expenses of owning, managing and preserving securities producing such income, provided the taxpayer will consent to the disallowance of expenses incurred in connection with tax-exempt securities.

The handling of the instant case in the Treasury Department is an example of the practice of which we speak. The Commissioner allocated the expenses between the taxable and tax-exempt income of the taxpayer and denied the portion thereof which he allocated to the tax-exempt income. However, when the taxpayer appealed from his decision, the Commissioner made no attempt whatever, either in the Board of Tax Appeals or in the court below, to sustain that action; but, in order to achieve his objective, in part at least, insisted that all of the taxpayer's expenses allocable to both taxable and tax-exempt securities should be disallowed on the ground that in their management he was not engaged in trade or business.

No matter how much one may sympathize with the feeling of the Treasury officials that taxable income should not be diminished by the deduction of expenses incurred in earning tax-exempt income, one cannot approve their attempt to achieve their objective indirectly by adopting a position which is not only at

variance with the 1934 amendment relating to expenses allocable to tax-exempt income and the settled interpretation of the statute of many years' standing, but is not even consistently followed in actual practice, and is advanced merely as a club to coerce taxpayers.

Even if, contrary to the express provision of the statute, it were considered desirable to disallow expenses incurred in the production of tax-exempt interest, such disallowance could not be accomplished completely or properly merely by placing a narrow interpretation on the words "trade or business" as used in Section 23(a). That would result in the disallowance of expenses incurred in earning tax-exempt interest, only in the case of taxpayers not engaged in "business" within the narrow definition contended for, while such expenses would continue to be allowed to other taxpayers. Moreover, in order to disallow the expenses of earning tax-exempt interest to taxpayers engaged in managing and conserving income-producing securities, it would be necessary to establish a construction of the term "business" which would result in the disallowance also of the reasonable and necessary expenses of earning taxable income.

Conclusion.

The administrative interpretation of the term "business" in Section 23(a), set forth in published rulings, as including the activities incident to the management and conservation of income-producing securities, and the long-established practice of allowing the deduction of expenses incident thereto as business expenses are sound, have become firmly embedded in the law, and should not be disturbed. The decision of the court below is contrary to such interpretation and practice, is incorrect and should be reversed.

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